PAY FOR SUCCESS PROGRAMS:

AN INTRODUCTION

By Drew Von Glahn and Caroline Whistler

Why the Burgeoning Interest in Social Impact Bonds?

At the 2011 APHSA Spring Policy Forum, there was a great deal of interest in social impact bonds. The initiative—increasingly referred to as Pay For Success (PFS)—combines funding, program evaluation and program management. Its goal is to improve social outcomes while more effectively allocating scarce public-sector resources.

In its simplest form, Pay For Success is constructed as follows:

- Government contracts for social service programs to address a societal need.
- Philanthropic funders provide the financial resources to pay for the program.
- Government, service providers and philanthropic funders agree upon targeted social outcomes.
- Independent evaluators monitor program performance.
- Should the program achieve the agreed metrics, the government will be able to reimburse the initial funders for their "invested capital" and reinvest in the program. If the program fails to meet the targeted outcomes, the state agencies are not obligated to repay the investors.

Under the Pay For Success construct, performance risk is transferred to the philanthropic funders. An additional attraction is that these programs often drive fiscal savings along with improved outcomes for the targeted population.

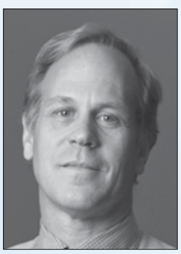
As we walk through the concept, its construct and its application, several themes regarding PFS emerge.

- It is applicable to a broad range of social imperatives.
- It results in a "rebalancing" of our fiscal expenditures. Dollars will move toward preventative programs with successful outcomes.
- It builds upon existing components such as: proven social interventions, performance-based contracting and philanthropic investment in innovative ideas.
- PFS is a new "tool" that strengthens the connection between government accountability and improved lives.
- Successful programs will allow for replication, building to scale.
- It maintains a focus on high-quality care. PFS is not about cutting services, but rather taking to scale proven approaches that achieve better outcomes.
- It promotes a cycle of continuous innovation in the sector.

How Does It Work?

Now let's get into the construct; its background and the expected application here in the United States.

The Social Impact Bond was coined based on a program initiated in the United Kingdom last year. In a desire to reduce recidivism among short-stay offenders, the government contracted the services of several social organizations with track records for positive outcomes in this area. *For more details please see our paper in the*



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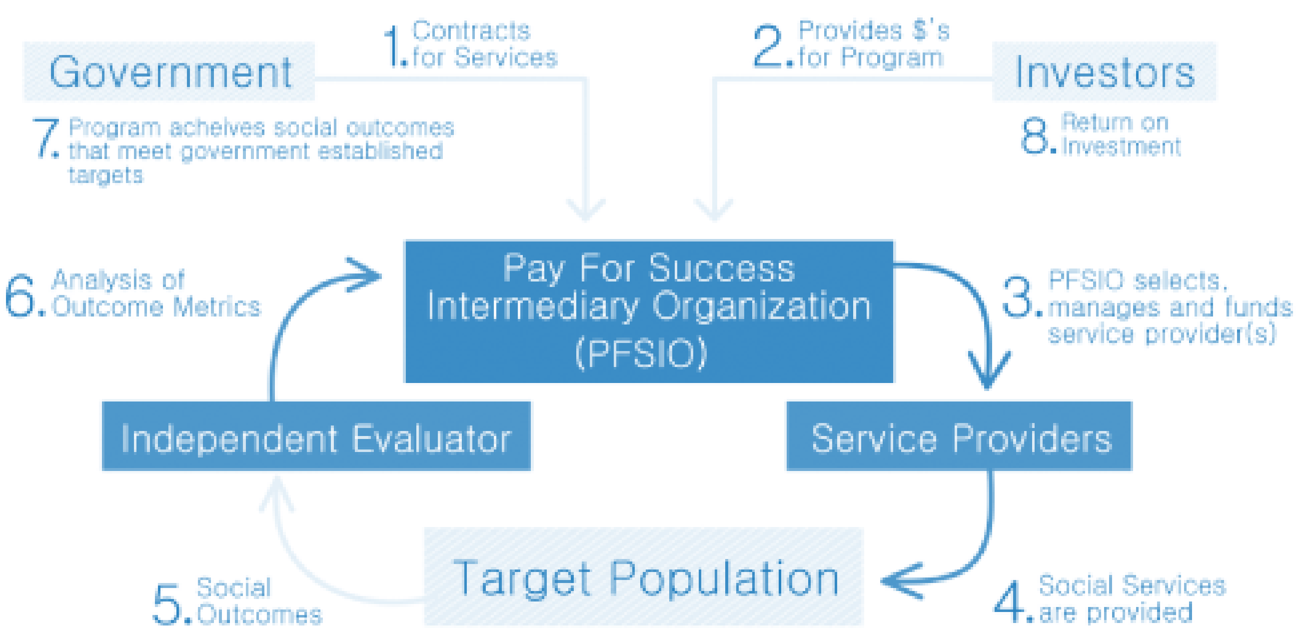

1: The government contracts the Pay for Success Intermediary Organization (PFSIO) for services. **2:** The investors provides the resources for the Program. **3:** The PFSIO selects, manages and funds service providers. **4:** The Service Providers offer social services to a target population. **5:** The PFSIO manages providers to ensure social outcomes are met. **6:** Independent Evaluators and PFSIO verify outcomes through rigorous processes. **7:** Program acheives social outcomes that meet government established targets. **8:** If social outcomes meet government set targets, investors receive a return on investment. Otherwise, government is not obligated to make any payments.

Federal Reserve Bank of San Francisco's March 2011 journal, "Translating Plain English: Can the Peterborough Social Impact Bond Construct Apply Stateside?" http://www.frbsf.org/publications/community/review/vol7_issue1/Glahn_Whistler.pdf/.

The multi-year program was funded by philanthropic organizations, with the promise of a return on investment if agreed-upon targets were met. As the British government stated at the time:

> *"…[the] SIB pilot is the first scheme in the world that has used new funding from investors outside government to reduce reoffending with offenders. Investors will only receive returns on their investment from the Ministry of Justice if they reduce reoffending by a set amount."*

In the United States, the terminology has changed a bit, and has since become increasingly referred to as "Pay for Success."

The chart above illustrates the mechanics of a PFS.

As shown above, there are five key players. Let's work through the participants, their roles and expectations.

Service Provider(s): In contracting for services, the PFS construct allows for single providers or a "wrap around" approach which coordinates the independent skills of multiple organizations. These organizations would have proven on some scale to have achieved successful outcomes. In discussions with service providers, government officials and funders, programs that initially may be of most interest could include: early childhood interventions, education preparation and performance, recidivism, youths with disabilities, elder care services and workforce engagement.

Pay For Success Intermediary Organization (PFSIO): A key part of the construct, and one of its more unique aspects, the PFSIO plays the role of the primary contractor with the government and the primary obligor to the investors. In this capacity, the organization oversees the program providers and monitors their performance. The PFSIO, with its focus on achieving social outcomes, has the ability to hire and fire the contracted service providers.

Investors: PFS programs are designed to apply the mechanics of the established capital markets. Private dollars provide the initial "risk" capital for PFS projects. While philanthropic in their focus, the PFS construct allows investors to receive a return on their initial investment. We anticipate that in the initial phase of implementation, PFS will be funded by traditional philanthropic organizations. Over time, it is expected that the PFS instrument will allow for an even broader population of investors. *For more on impact investors, please see the Hope Consulting May 2010 report "Money for Good" http://www.hopeconsulting.us/pdf/Money%20for%20Good_Final.pdf/.*

Independent Evaluators: PFS is about "funding what works." Hence, independent evaluators play a significant role in the Pay For Success construct. To truly "move the needle," PFS programs need to have measurable and real improvement in the lives of the targeted population, requiring robust evaluations to be incorporated into PFS programs. Given the application of administrative data to track whole populations, it is expected that the cost and complexity of the evaluation process will decline.

Local Government Entity/Agency: Pay For Success programs will be wholly dependent upon the commitment and engagement of government agencies. They will need to indentify priority areas for a PFS intervention, determine desired social and fiscal outcomes and commit themselves to the process.

The PFS construct builds upon existing pay-for-performance contract structures and evaluation initiatives in government today. Fred Wulczyn of Chapin Hall, who has been instrumental in structuring these types of contracts, states that "… pay-for-performance contracts provide an exceptional foundation for states looking to explore alternative mechanisms [such as PFS] for funding social programs." In most states, regulatory changes may be needed to allow for multi-year contingency based contracting—and we expect states to take various routes to achieve the necessary regulatory flexibility to engage in Pay For Success structures.

In a PFS construct, the government reduces its risk associated with innovative social programs. As in the capital markets, the investors take the performance risk. The government pays only for those programs that meet pre-agreed outcomes, both social and fiscal.

Another player that has not been addressed in this representation is the federal government. The FY 2012 federal budget includes $100 million to fund Pay For Success programs at the state and local levels. The proposed budget allocation also includes the necessary provisions for federal agencies to support multi-year contingent contracts.

What Is the Value Proposition for State and Local Governments?

Pay For Success can be compelling for state and local governments for the following reasons.

Fiscal Realities: The current fiscal climate has made even the funding of existing programs more difficult, threatening health and human service results across the board. A recent Gallup poll found that Americans are most likely to favor cutting back on state programs (65%) as a way to balance their own state's budget. With program reductions imminent, PFS allows departments to continue to serve their state's most vulnerable constituents.

Innovation Driver: Wulczyn refers to Pay For Success programs as "investing in success." As a vehicle to support new initiatives, PFS will relieve pent-up demand for innovation in the human service sector. By leveraging private funding, PFS provides "R&D capital," allowing government to innovate and evaluate even in times of fiscal constraint. Pay For Success builds on states' existing efforts to drive social change.

Fiscally Prudent: In a PFS construct, the government reduces its risk associated with innovative social programs. As in the capital markets, the investors take the performance risk. The government pays only for those programs that meet pre-agreed outcomes, both social and fiscal. This is a prudent use of a state/locality's financial resources.

Rebalancing: PFS programs help move states and local governments away from social "safety net" programs to preventive efforts. As one expert observed, it is often difficult for government organizations to pay for programs that prevent situations. PFS allows for the development of a system that establishes and rewards preventive initiatives, thereby moving fiscal dollars to the "front end" of social needs.

What Will It Take to Implement?

Government Engagement and Planning

States are in various levels of pursing PFS programs. Jeffrey Liebman, former OMB deputy director and Harvard

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professor, recently wrote an insightful piece on Pay For Success. (See Jeffrey B. Liebman "Social Impact Bonds: A promising new financing model to accelerate social innovation and improve government performance," The Center For American Progress's February 2011 journal, *http://www.americanprogress.org/issues/2011/02/pdf/social_impact_bonds.pdf/*.) He anticipates that *"…in most cases, states will want to follow a two-step process. The first stage would be an RFI process seeking program ideas from a wide range of experts, especially those in the local social service community. With this input, state agencies can narrow down to a few high priority ideas and solicit RFPs in those targeted areas."* Liebman is currently offering pro bono assistance to several states that are considering whether the Pay For Success approach can help them achieve their policy and performance goals.

Additionally, federal OMB officials have indicated that *"States don't necessarily need to wait for the Federal 2012 budget—they can start looking now at what kind of programs they would be interested in using for a Pay For Success type framework. They could start identifying and collaborating with potential partners and intermediaries, and most importantly looking at existing authorities and funding flows that can leverage Pay For Success structures."*

At Third Sector Capital Partners, we seek to play a role in supporting the growth of Pay For Success programs here in the United States. We have established ourselves as a nonprofit advisory boutique with a goal to assist each of the various parties; service providers, PFS intermediaries, state agencies and evaluators in designing and implementing Pay For Success programs across the country.

A Focus on Program Initiatives that Meet Certain Parameters

We believe that successful PFS initiatives will include the following characteristics:

- Support from state and local agencies that view the dual goal of achieving social outcomes and better utilizing fiscal resources as a priority;
- Programs that have demonstrated the ability to achieve measurable social outcomes;
- Service providers with experienced management teams;
- Programs that can demonstrate "cashable" fiscal savings for government;
- Programs that focus on high quality of care;
- Programs with an ability to replicate and become sustainable; and
- Cost-effective access to credible data.

Use of Performance-Based, Multi-Year Contingency Contracting

While a number of states have developed performance-based contracting, there is not universal acceptance of performance-based contracts in the health and human service arena. An additional requirement will be incorporating multi-year contracts, as it will take time for a program to demonstrate outcomes. Many state regulations limit the ability to commit over multiple budget periods. However, mechanisms are being developed that allow the necessary contracting constructs. The recent federal OMB PFS budget proposal similarly includes constructs to allow multi-year contingency programs.

Robust Evaluation Process and Procedures

A key component of the Pay For Success model is the use of independent evaluations to confirm that program quality is maintained, process requirements are followed, and established social metrics are achieved. This is critical, as PFS is seeking to engage all parties around "funding what works." For example, Chapin Hall has developed the capacity to use states' data on whole populations to develop statistical models for comparing program outcomes among similar populations.

Making the Case for Pay For Success Programs "Concrete"

It will be imperative that discussions of PFS are framed in very concrete terms. Outcomes need to be tangible and measurable, such as reduced recidivism rates and lower utilization of foster care placement. The analyses of fiscal savings need to be demonstrated in quantifiable numbers, such as a reduction in special education dollars, lower Medicare payouts and lower juvenile justice expenditures.

Commitment and Perseverance

Lastly, implementation of a new tool such as Pay For Success will inevitably run up against unknowns—requiring the willingness of all the involved parties to maintain a focus on the end goal—improving lives while fiscally managing taxpayers' resources.

In a time when budgets are being slashed and innovation appears to have little bandwidth, Pay For Success programs are a potentially empowering tool for state and local governments to allocate their dollars toward the greatest outcomes for constituents. At its core, this construct has the potential to leverage private-public partnerships to transform the way state and local governments finance social programs in this country. Several state governments are seriously pursuing the implementation of this new tool, and our hope is that concrete examples of this work will be available in the near future.